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The International Accounting Standards Board  
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**Concerns: RFI - Post-implementation Review IFRS 9 Financial Instruments Impairment**

Dear Sir, Madam,

As a provider of a software solution for IFRS9 impairment calculations, we welcome the opportunity to share some of our insights, gained during numerous implementations at financial institutions.

We find that most IFRS9 principles work well and provide clear added value. However, a few aspects turn out to be hard to implement or difficult to reconcile with best practices in credit risk management.

We hope that you will find our technical feedback on questions 3 (SICR), 4 (ECL) and 6 (POCI) useful and are available for further discussion.

Yours sincerely,

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**Question 3—Determining significant increases in credit risk****(b) Can the assessment of significant increases in credit risk be applied consistently? Why or why not?**

*The IASB noted that, in order to meet the objective of recognising lifetime expected credit losses for significant increases in credit risk since initial recognition, it might be necessary for an entity to perform the assessment of significant increases in credit risk on a collective basis by considering information that indicates significant increases in credit risk on, for example, a group or subgroup of financial instruments. The collective assessment would ensure that an entity could meet the objective even if evidence of such significant increases in credit risk at the individual instrument level was not yet available. To recognise a loss allowance on a collective basis, an entity can group financial instruments on the basis of shared credit risk characteristics.*

It remains unclear to us how such a collective staging exercise should be implemented in practice, given that the IFRS9 stage and impairment should still be assigned at the level of individual contracts in the end.

Consider for instance a portfolio of 10 000 very similar credits, currently all in stage 1.

- We foresee a strong rise in unemployment and expect that it will have a significant impact on this portfolio. However, the unemployment rate has not been included in our ECL model, or staging logic.
- We therefore perform a separate collective assessment that properly accounts for the rise in unemployment. It indicates that 10% of contracts in the portfolio will experience a significant deterioration of credit risk and each of them should see its lifetime ECL increase by 100 CU.

Since all credits are nearly identical based on the individual data we currently have, we see no other option than to randomly select 1000 credits and put them in stage 2, with an increased impairment. This would work if IFRS9 were a pure accounting exercise, but we have worked hard to make sure that the IFRS9 impairments are used in a wider range of processes, such as risk-based pricing ('use test'). The users of our impairments would lose confidence if they were confronted with unexplainable differences in stage and impairment amount.

#### Question 4—Measuring expected credit losses

**(a) Are there fundamental questions (fatal flaws) about requirements for measuring expected credit losses? If yes, what are those fundamental questions?**

The treatment of penalty interests when discounting future recovery cash flows requires further guidance. There is no problem with the discounting of future expected cash shortfalls to the reporting date, which should clearly be done at the effective interest rate. The problem is rather in the calculation of the expected cash shortfalls themselves (the ‘loss given default’ calculation) before they are discounted to the reporting date to obtain the ECL. It also arises when estimating expected credit losses of stage 3 contracts in irrecoverable default.

The following somewhat artificial example illustrates the issue:

- A bank has issued a credit at an effective interest rate of 1% annually. In case of default, the fine print of the contract stipulates that interests will continue to accrue at the effective interest rate, increased by a penalty rate of 10% per annum.
- On 1/1/2024, the credit is put in default as payments of capital and interests have come to a complete stop. The total amount due at that moment equals 1000 CU.
- Despite the default, the bank expects to recover the full amount due on 31/12/2024, via an incoming cash flow of 1110 CU = 1000 CU + 10 CU + 100 CU. No intermediate cash flows are expected.

The accounting team tries to compute the ECL, but each colleague sees things differently:

- Colleague A considers that recovery cash flows related to penalty interests must be disregarded when computing the ECL. This is easy in this somewhat artificial example:

$$ECL = 1000 \text{ CU} - \frac{1000 \text{ CU} + 10 \text{ CU}}{(1 + 0.01)} = 0 \text{ CU}.$$

- Colleague B includes penalty interests in the ECL calculations as extra recovery cash flows, to be discounted at the expected interest rate, which leads to a counterintuitive negative impairment:

$$ECL = 1000 \text{ CU} - \frac{1000 \text{ CU} + 10 \text{ CU} + 100 \text{ CU}}{(1 + 0.01)} = -99 \text{ CU}.$$

- Colleague C considers that penalty interests are an integral part of the credit agreement and should therefore be included in the ECL calculations. However, she finds that this only yields meaningful results if recovery cash flows are discounted to the moment of default at the effective interest rate, *increased by the penalty rate*:

$$ECL = 1000 \text{ CU} - \frac{1000 \text{ CU} + 10 \text{ CU} + 100 \text{ CU}}{(1 + 0.01 + 0.1)} = 0 \text{ CU}.$$

Credo’s opinion is that only the last option will work in practice. The problem with option A is that in more realistic situations, it is not trivial to filter out the part of recovery cash flows that covers penalty interests. As for option B, it easily leads to negative loss given default values, even in situations for which the bank considers that it did not receive all agreed amounts.

## **Question 6—Purchased or originated credit-impaired (POCI) financial assets**

**Can the requirements in IFRS 9 for purchased or originated credit-impaired financial assets be applied consistently? Why or why not?**

All banks we interact with have aligned their definition of stage 3 under IFRS9 with the Basel/EBA prescriptions for identifying defaulted credits. Doing otherwise would be prohibitively expensive and would lead to a loss of buy-in of stakeholders throughout the bank and banking supervisors.

The definition of default imposed by regulators covers multiple situations:

- a) Irrecoverable default – credits that are deemed beyond the point of no return, for which the workout department starts to realize collateral.
- b) Credits that are more than 90 days past due on capital or interests but may still ‘cure’ and return to a healthy status.
- c) Credits that have cured but are still in their probation period.
- d) Credits that are paying capital and interests as they should but are deemed ‘unlikely to pay’ for good other reasons.
- e) ...

The separate IFRS9 approach for measuring interest recognition and expected credit losses of POCI assets makes sense to us in the case of irrecoverable default, but less so in other default situations, for which the expected cash flows are quite close to those expected for non-defaulted credits.

A good illustration is the situation in which bank X acquires bank Y, including its defaulted credits, which must be accounted for as POCI credits thereafter. Many of these POCI credits will cure and become a part of the large pool of non-defaulted credits of the bank. But their accounting treatment will remain very different from other credits that are otherwise very similar. Few stakeholders will understand what is happening.

An important practical point is also that implementing the POCI approach for assets that are not in irrecoverable default or have cured will be prohibitively difficult for many banks. It is much harder than in the case of POCI assets in irrecoverable default, for which only a few cash flows remain to be dealt with.

We have a similar observation regarding the interest recognition on regular non-POCI stage 3 exposures. Applying the effective interest rate to the amortised cost makes sense in the case of irrecoverable default but it feels artificial for other types of default, in which the credit is often still paid back regularly.